

Managing the Financial Supply Chain

However, the company should try to determine the reasons for a lengthy DSO before taking actions to reduce it as there may be underlying factors which need to be addressed first. For example, payments may be delayed due to inefficiencies or errors in the company's invoicing processes rather than delays originating from the customer.

Retail is traditionally run with negative working capital, so we're taking payment from our customers over the tills before we've paid our suppliers. As a UK food retailer we run with significantly less creditor days than our international competitors, such as Carrefour and Ahold, who pay their suppliers significantly later than Tesco does. Tesco pays our trade creditors in 32-35 days; our competitors would be paying them in 60 days plus, which puts us at a disadvantage in terms of our funding arrangements. Having said that, Tesco is pretty good at our stock management, and the number of days' stock that we have in our supply chain compensates for our early payment terms. So if you look at our net negative working capital we are probably competitive with Carrefour and Ahold.

"I think the thing that's become clear to us as we've moved more into non-food and also expanded internationally is that UK food retailers have significantly faster payment terms than our international competitors. These terms of trade and payment terms have developed over time, and if you started with a blank sheet of paper, you'd query whether the UK has necessarily got its funding correct.

The prime focus of working capital management is making sure that the financial supply chain is efficient, and that managing stock within the business is efficient - those are the two big drivers. We look to manage to negative working capital of about 15 days and we have 34 days' trade creditors and 16 days' stock within the business. That varies according to which country we're operating in. Korea and Thailand potentially have longer payment terms and also more stock days depending on the mix of food and non-food.

Nick Mourant, Group Treasurer, Tesco



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Another possible course of action to optimise receivables is enforcing standardised payment terms as companies frequently operate varied payment terms for different customers, making it difficult to get a consolidated view of the payables outstanding. Implementing clear policies regarding payment terms and which companies are allowed to deviate from them, and by how much, should also help to improve the company's working capital position.

The reduction of overdue receivables often provides a quick-win critical to obtaining buy-in and thus to creating momentum.

Markus Koch, Partner, Advisory Practice, PricewaterhouseCoopers

Payables

Just as receiving payments quickly allows a company to put cash to work sooner, the longer the DPO, the longer the cash is available for the company to use. As discussed in Section 1, there is a growing trend for large multinational companies to extend the payment terms offered to their suppliers in order to increase DPO. As this is not an attractive option from the point of view of the supplier, the success of this approach is largely dependent on the power balance in the supplier-purchaser relationship.

The purchaser should also bear in mind the consequences that may result from extending payment terms, particularly in volatile and uncertain markets. For example, early payment discounts may be sacrificed, or the company's relationship with the supplier may be adversely affected.

The impact on the company's reputation amongst other current or future suppliers should also be considered, as should the possibility that the supplier might realistically need the purchaser's funds to stay in business, and therefore the supplier may need to be paid even earlier.

Inventory

Unlike DSO and DPO, which relate directly to the flow of cash in and out of the company, DIO relates to the status of physical assets. 'Inventory' includes raw materials, works in progress and finished goods – while they are still held by the company.

The efficiency of inventory management processes depends on the accuracy of forecasts. If demand for a product can be forecast accurately, it will not be necessary to hold a significant surplus of inventory. The impact of taking up bulk purchase discounts should also be assessed as this increases the level of inventory held in stock, impacting on working capital as well as storage and insurance costs.

Adopting a just-in-time production model can be used to reduce the level of inventory held by the company. However, as discussed on page 7, this type of approach does come with a risk. The just-in-time model exacerbates supplier risk: if a supplier fails to deliver the required products on time, the impact of this will be far greater for a company that holds a lower level of inventory. Often there is an internal battle over inventory volumes as it is really only in the eyes of the CFO or treasurer that low levels of inventory are beneficial. For example, procurement may wish to order in bulk so as to achieve better prices, and the sales department will want there to be sufficient stock for them to be able to deliver product to their customers quickly. This calls for a balancing act between departments to ensure inventory is kept at an optimum level.

The ideal level of working capital

The level of working capital that is seen to be the most comfortable will vary from company to company, with some preferring a greater buffer zone and others preferring to pare down the amount of cash invested in the business as far as possible. The decision equates to a trade-off between profitability and risk.

Conservative

A conservative approach to working capital management means reducing the risk of running out of supplies with the consequential delays in production and damage to sales by holding a comparatively high level of inventory. This need for higher levels of working capital in the business will have to be funded.

Aggressive

In an aggressive working capital strategy, on the other hand, working capital is reduced to minimal level. In other words, the levels of working capital are lower than if a conservative approach were taken. Profitability is therefore enhanced, but at the same time the company is exposed to a greater risk of disruption to productions and sales and there may be higher management costs associated with running the company 'on the edge'. Many companies aim for an aggressive approach but ease back when the worst 'pain points' are identified.

Investing working capital

A reduction in working capital should leave the company with more cash or with a reduced financing requirement. In the former case, the company should consider options for investing any surplus cash in order to achieve a higher return. Different options are available depending on what the cash is ultimately needed for.

Genuinely surplus cash can be invested in long-term vehicles in order to achieve the maximum return. Cash that is to be used as a 'buffer zone' for working capital fluctuations should be invested shorter term thus providing easy access to cash and avoiding the need for external financing.

Releasing trapped working capital

Relying on short-term debt can be a risky strategy in turbulent times and companies should be focusing on freeing up working capital. However, it is important for management to do this without undermining the organisation's business operations, ethics and industry standards for good practice. Processes to review include:

- How are invoices produced – on paper or electronically?
- What is the lead time on delivery of invoices?
- Are payments usually on time?
- What happens when a payment is overdue?
- How are reminders or statements of account sent?
- Is the company getting value for money with its current suppliers?
- Are available discounts being used to the company's best advantage?

Other key areas that may be masking working capital inefficiencies are staff productivity and inventory. Many companies use financial ratios and metrics to monitor inefficiencies, and examples of such metrics include inventory turnover and profit per employee ratios. Such metrics are also useful in benchmarking a company's performance against its peers.

How can these inefficiencies be addressed?

The second step in releasing trapped working capital is to identify the ways in which any inefficiencies can be resolved. The majority of inefficiencies occur with manual processes which are labour-intensive and also carry a high margin of error. As such, technology and automation is often the answer for companies looking to release working capital through the optimisation of workflows. A good rule of thumb however is to put your own house in order before looking externally. This means that there may be structural measures that could be implemented internally at little or no cost before employing technology to resolve any issues.

Industry trends can also be useful indicators as to how other companies are addressing the same inefficiencies. For example, the trend towards centralised treasury is an illustration of a structural measure that can help to reduce working capital inefficiencies through the consolidation of tasks and increased control and visibility. Another contemporary example is the move towards e-invoicing, and we will cover this in more detail in Section 4.

Optimising working capital

Many people think that releasing working capital is the same as working capital optimisation (WCO). However, as we have seen above, releasing trapped working capital is simply reviewing inefficient processes, whereas WCO is more about getting an effective chain in place. This means driving efficiencies right the way from the supplier to the customer to maximise working capital efficiencies. According to Rebecca Adriatico, Head of Global Product Management, Trade and Supply Chain, HSBC, "Treasury and supply chain managers are becoming more engaged to support finance in working capital optimisation programmes not just within their own organisation but for the wider supply chain eco-system."

As John Mardle, Working Capital Practice Leader at Deloitte and Partners explains, "A lot of our top clients are focused on how to deal with processes on a siloed basis, with no idea in the meantime that if they'd actually just asked the correct questions in the first place and dealt with the chain holistically, they could have got payment in from the customer a lot earlier because they could have delivered a lot quicker. As such, it's not necessarily about optimising the processes but understanding the flows involved."

Working capital optimisation can also be very much an exercise based on people, from the staff who deal with suppliers to the customers themselves. This is where the focus on CRM (discussed in Section 2) becomes more intense. Though, as John Mardle goes on to say, "We've actually changed that round to say customer retention management, not relationship management, because at the end of the day, it's going to cost you seven times more to get a new customer than it costs to retain an existing one. So people shouldn't really be looking that hard into new customers right now, but more maintaining their existing customer base."

WCO checklist

We asked John Mardle to provide his top ten tips when looking to achieve working capital optimisation:

1. WCO programmes must extend beyond the finance function and engage the company's entire managerial team. Do not think that all working capital management problems can be addressed by treasury alone.
2. Do not artificially adjust working capital levels through delaying payments to suppliers or indiscriminately stepping up collection activities in order to boost quarter- or year-end performance metrics. In business, as in physics, every action is met with an opposite reaction. Delaying payments to vendors may reduce working capital over the short term, but that improvement is likely to disappear over time as vendors adjust their pricing accordingly.
3. Incentivise people to achieve their WCO targets by compensating staff accordingly, particularly at managerial level.
4. Make a consistent effort to optimise working capital. It may be tempting to take the focus away from working capital when the company is growing as there may be less immediate need for it. Equally, in times of crisis, attention can be diverted elsewhere. Ignoring working capital during a downturn could significantly inhibit a company's ability to grow and meet demand once business rebounds.
5. Ensure all hopes are not pinned on ERP implementation. Although ERP systems can provide significant benefits in the working capital arena, in the near-term they can cause deterioration in working capital performance as key managers and employees are distracted from their daily routines and forced to fine-tune the new ERP system.
6. Connect suppliers and customers across the enterprise to achieve maximum benefits.
7. Negotiate before it is too late. Use the company's leverage as a prompt-paying customer to help your bargaining position for better discounts or extended payment terms. This could not only provide cost benefits but also retain the goodwill of your suppliers.
8. Do not allow debt to become overdue before identifying and resolving disputes. Contact customers before payments are due to resolve any potential disputes and for delinquent payments, assign collection responsibilities to individuals and escalate the responsibility to more senior employees as invoices become further overdue.
9. Develop forecasting techniques that incorporate intelligence from all relevant business segments, including not just sales but manufacturing, distribution and marketing. Evidence from these forecasts will assist in the production of company financial statements to investors.
10. Look holistically at the supply chain. For example, there is a direct correlation between inventory management methods and the level of customer service that a company can provide. Do not allow one area to suffer as a result of focusing attention on another.

Working capital and the financial supply chain

Most people involved in financial supply chain management agree that managing working capital is an essential component of this area and for many companies the starting point. As discussed, one of the key goals of financial supply chain management is identifying areas where working capital is trapped, then optimising processes in order to release it, ultimately consolidating needs for working capital in order to use it more effectively.

Working capital management has always been on the corporate agenda but companies were either reluctant to make the required efforts or have underestimated the effort which led to failed projects. While working capital is a limited intellectual challenge it is a very significant managerial challenge.

Markus Koch, Partner, Advisory Practice, PricewaterhouseCoopers

However, as we touched upon in Section 1, managing the financial supply chain means looking holistically at actions and their consequences throughout the chain. This has led to a heightened awareness that the types of actions traditionally taken in order to increase working capital (reducing DSO and DIO, increasing DPO) may have negative consequences on other parties in the chain – which may, in turn, have repercussions for the company in question. If you increase your DPO you are also increasing someone else's DSO. Suppliers are increasingly being put in this position by their large corporate customers who are following the trend of increasing payment terms from 30 to 60 or 90 days. These suppliers are therefore effectively financing their customers – at their own expense. Of course suppliers will try to pass this back to the buyer in the form of increased prices.

In order to address this problem, a financial supply chain management approach considers working capital and the associated balance sheet metrics not in isolation but with a view to its consolidated impact on the company's P&L. For example, this approach involves considering the total consequences of increasing DPO on the P&L. The treasurer is in a strong position to co-ordinate this by taking a wider view of working capital management and by providing financial measures for the true impact of any actions taken.